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THE WHITE HOUSE
WASHINGTON

July 15, 1985

MEMORANDUM FOR WILLIAM J. CASEY

FROM: ROGER B. PORTER RBP

The agenda and papers for the July 17 Meeting of the Economic Policy Council are attached.

THE WHITE HOUSE

WASHINGTON

July 15, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the July 17 Meeting

The agenda and papers for the July 17 meeting of the Economic Policy Council are attached. The meeting is scheduled for 4:00 p.m. in the Roosevelt Room.

The first agenda item is an examination of economic conditions in the farm sector and alternative legislative approaches. A paper prepared by the Department of Agriculture in coordination with the Council of Economic Advisers, the Office of Management and Budget, the Department of the Treasury, and the Office of Policy Development is attached. The paper describes the current economic conditions in the farm sector, reviews the objectives of the Administration's proposed farm legislation, and outlines the major farm program proposals under consideration in the Congress.

The second agenda item concerns agricultural credit policy. The Working Group on Agricultural Credit Policy has prepared a paper on the role the Federal Government should play in addressing the credit difficulties faced by many U.S. farmers and in facilitating adjustment to a more stable farm credit situation. This paper reviews the origins of the agricultural credit problem, the sources of agricultural credit, and the actions taken by the Administration thus far to address the agricultural credit problem. It focuses on the specific issue of how the Federal Government should address its increasing direct exposure to the agricultural credit problem through the Farmers Home Administration. A second memorandum will address the issue of how the Federal Government should address the problems of the Farm Credit System.

Attachments

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THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

July 17, 1985

4:00 p.m.

Roosevelt Room

AGENDA

1. Economic Conditions in the Farm Sector and Legislative Alternatives

2. Agricultural Credit Policy

Economic Conditions in the Farm Sector and Alternative Legislative Approaches

Current Economic Conditions

Fundamental changes in the economics of producing and marketing farm products since 1981 have left agriculture with far larger capacity to produce than demand for its products. Demand for U.S. farm products has stagnated over the last 3-4 years while the sector's capacity to produce has continued to expand. Macroeconomic, financial, policy, and weather developments here and abroad have slowed growth in domestic demand sharply and cut export demand more than 15 percent. Productivity growth, the maturing of investments made in the 1970's and price supports set high enough to weaken producer incentives to adjust have combined, however, to keep agriculture's production capacity expanding 1.5-2 percent per year.

After a temporary respite in 1983-84 due to PIK and the drought, the sector has returned to the point of serious oversupply. Commodity prices will continue at and possibly slip below loan levels due to the sheer size of the surplus.

Given this bearish outlook, farm income will remain under considerable downward pressure and direct government payments will become an increasingly important source of income. Net cash income could fall 5 percent in 1985 with a growing proportion (20%) made up of diversion and deficiency payments. The Commodity Credit Corporation's operating expenses could exceed $17 billion, a record second only to expenses during the PIK year. In this setting, land values are also likely to continue dropping. Values declined 12 percent from April, 1984 to April, 1985 after declining 7 percent from 1981-84. Added asset erosion in 1985 will push an increasingly large number of operators into highly leveraged positions or technical insolvency.

Higher supports could raise commodity prices the 20-30 percent needed to forestall further adjustments. The cost of high enough supports to prevent further income and asset adjustments, however, would be large -- possibly twice the $14 billion per year average so far in the 1980's, as well as further erode our export competitiveness.

In this environment, the sector faces continued financial pressure for 2-3 years more until sufficient resources leave agriculture to bring production capacity back into balance with demand. Farm incomes could fall $2 to $4 billion further (5 to 10 percent), while land values could slip another 10-20 percent. A drop in support rates that allowed commodity prices to fall to market-clearing levels would result in even greater losses in farm income--possibly $6-8 billion--and further declines in land values.

While operators facing both cash shortfalls and serious asset erosion make up only 10 percent of farms, they account for more

than 45 percent of farm debt. Their increased difficulty in meeting principal and interest commitments has become a serious problem for the Farm Credit System, agricultural banks, and the Farmers Home Administration. Agricultural lenders have also come under pressure directly as a result of declining asset values, deteriorating loan portfolios, and falling rental returns.

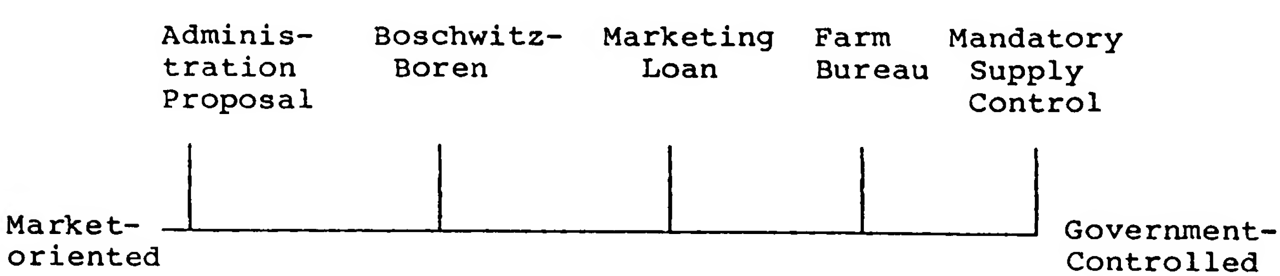
Proposed Farm Legislation

The Administration will face considerable pressure from a broadening circle of farm, agri-business and banking interests to intervene through omnibus farm legislation to strengthen farm prices and stabilize land values. Indeed, the prevailing concern from the Congress is the necessity of protecting farm income. While some proposals under consideration will enhance farm income over the next few years, none will maintain farm income in 1986 at the 1985 level. More importantly, all the price and income support programs under consideration will be costly.

The objective of the Administration's farm policy is to reorient U. S. agriculture towards the market place so that farmers have an opportunity to react to market signals rather than to artificial support rates set by the government. In the long run a market-oriented policy will preserve the independence of the U.S. farmer while allowing him to retain his competitive edge in both domestic and world markets. In the short run, however, U.S. agriculture, partly as a result of previous farm policy, is faced with excess capacity, an extremely low income-generating ability in the free market, and a debt problem that is approaching unmanageable proportions. The new farm legislation should promote a prompt, orderly and efficient transition to the free market while providing a basic level of income protection to farmers in the interim.

The farm program proposals under consideration encompass the policy spectrum from market-orientation to mandatory supply controls. Following is an overview of the major farm proposals.

Basic Farm-Program Options



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Approach 1: Transition to a free market with declining price supports (Administration 1985 Proposal)

The Administration's farm bill proposal is market oriented by reducing price and income supports and tying them more closely to past movements in market prices. Acreage reduction programs are phased out with a three-year transition period.

Advantages

- The Administration's proposal allows farmers to respond to market signals rather than artificial support rates enhancing our competitiveness in world markets.

- This is the least costly proposal advanced with projected outlays totaling $22 billion for FY 1986-88.

Disadvantages

- The agricultural community and the Congress perceive the proposal as far too austere since the reduced price and income supports would result in a sharp drop in farm income in the short term.

- The proposal has not received serious consideration in the Congress and is effectively dead.

Approach 2: Move quickly to free market and provide direct income transfer (Boschwitz-Boren)

This proposal discontinues income supports (target prices) and drastically reduces price supports (loan rates). In its place, direct income transfers (transition payments) are provided to producers to protect farm income.

Payments are made on a per-bushel basis and based on a farmer's previous level of crop production. The payment would be established at a level that would provide the same income over variable costs a farmer received in 1985. Payments are targeted to small and medium-sized farm operations by reducing the percentage of the transition payment a farm receives as its output increases. No cropping restriction would be in place and producers would not have to plant a particular crop to receive the transition payments. Farmers are free to respond to market forces. Payments would decline over time. The legislation could be amended to reduce the cost and totally eliminate payments in 5 years.

Advantages

- This approach effectively separates income support from price support, providing the most efficient means of allowing U. S. agriculture to become more competitive internationally and to provide producers income.

- Its intent is to remove the government from farm supports within five years.
- It is the most effective way to provide producers income support.
- It would lower prices to consumers immediately.

Disadvantages

- The near-term budget costs are large, totalling $51 billion from FY 1986-88.
- The use of direct income transfers would expose the entitlement nature of farm programs. Currently, program payments are disguised welfare payments. Thus, direct payments may not be politically palatable to many farm groups.

Approach 3: Continue income support with market determined farm prices (Marketing Loan Concept)

Under this approach, a marketing loan program would be established which would allow a producer utilizing the commodity loan program to buy back the loan during the redemption period at the original loan rate or the market price at the time of repayment, whichever is lower. If the market price is less than the loan rate, the Commodity Credit Corporation (CCC) will incur the loss (the difference between the loan rate and the "market buy-back price").

Advantages

- Prices would be at levels closer to those determined by the market.
- The U.S. would become more competitive in world trade and regain lost markets.

Disadvantages

- It would result in much greater loan activity, increasing the initial loan outlays.
- The "buy-back" payment is not subject to a payment limitation and it could result in substantial payments to individual farmers. Estimated outlays for FY 1986-88 total over $37 billion.
- It would keep excessive resources in agriculture.
- Foreign governments would object strongly to this as a subsidized export program.

Approach 4: Gradually move toward a free market (Farm Bureau)

Price supports are continued as a percentage of past market prices and initially are allowed to drop no more than 10 percent a year. Income supports (target prices) are frozen in 1986 at 1985 levels and then gradually reduced 5 percent annually. Acreage reduction programs would be continued through 1989 and tied to projected total carryovers of respective commodities.

Advantages

- o This approach attempts to maintain farm income through the traditional loan rate-target price system while enhancing price competitiveness for U.S. farm products in world markets.

Disadvantages

- o The proposal moves toward a market-orientation very gradually, significantly delaying resource adjustment.
- o Farm exports will continue to decline for several years. Imports of program products may become profitable.
- o The use of acreage reduction programs continues the U. S. making unilaterally supply adjustments for the rest of the world.
- o Budget outlays over FY 1986-88 would approach $32 billion.

Approach 5: Impose mandatory production controls (House Agriculture Subcommittee)

This proposal would require the Secretary of Agriculture to proclaim national marketing quotas for major program crops (wheat, feed grains, cotton, rice and soybeans) and determine the acreage each farmer could plant of each commodity. A producer referendum would be held to determine whether producers approve or disapprove the quotas. In the event quotas are disapproved, producers would receive price and income protection at much higher levels. Total outlays would approach almost $39 billion for FY 1986-88.

Advantages

- o Large program payments would enhance farm income.
- o If mandatory controls are implemented, net outlays would total an estimated $32 billion for FY 1986-88.

Disadvantages

- o Mandatory acreage programs would result in idling as much as 90 million acres of cropland base. This compares to the 77 million acres idled under the PIK program in 1983.

- o Input industries (fertilizer, farm machinery, seed, chemicals, etc) would face reduced operating capacity despite more intense farming of the remaining cropland planted.

- o The level of exports of grains and soybeans would decline dramatically, in terms of both volume and market share. Imports of grains would become profitable and would have to be restricted through Section 22 import quotas.

- o Major commodity groups including the American Soybean Association, National Corn Growers, the Farm Bureau, and the National Grange oppose this approach.

THE WHITE HOUSE

WASHINGTON

July 15, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: THE WORKING GROUP ON AGRICULTURAL CREDIT POLICY

SUBJECT: Agricultural Credit Policy:
Farmers Home Administration

Issue: What role should the Federal Government play in addressing the credit difficulties faced by many U.S. farmers and in facilitating adjustment to a more stable farm credit situation? If Federal intervention is needed, in what form should it be provided?

This memorandum reviews the origins of the agricultural credit problem, the sources of agricultural credit, and the actions taken by the Administration thus far to address the agricultural credit problem. It focuses on the specific issue of how the Federal Government should address its increasing direct exposure to the agricultural credit problem through the Farmers Home Administration. A second memorandum will address the issue of how the Federal Government should address the problems of the Farm Credit System.

Origins of the Agricultural Credit Problem

The farm sector is now undergoing a necessary correction to the extraordinary agricultural boom of the mid- and late-1970's. In the 1970's, overall demand for U.S. farm products grew rapidly, with export markets expanding dramatically. Increased demand, rising productivity, and declining labor inputs caused real income from assets to rise sharply. In response to these incentives, augmented by government farm support programs, the tax code, and negative real interest rates, capital investment in agriculture increased and land values were bid up. Debt rose about as fast as the increase in assets. An increasing share of debt was provided by the Federal Government and the Farm Credit System (FCS), which played a major role in financing land speculation.

In the 1980's, the annual growth of demand slowed to only 1 percent for some commodities and actually declined for others. The appreciation of the dollar and the slowdown in economic growth abroad slashed exports. The relative decline in demand, combined with several bumper crop years, undermined farm prices. High interest rates over the last six years also reduced income. The less profitable outlook for farming, high real interest rates, and reduced inflationary expectations, pulled down farm land prices and assets while debt rose, squeezing farm equity.

Field crop and livestock operators in the Corn Belt, Lake States, and Southern Plains are facing the greatest financial difficulties. As of January 1985, 9.9 percent of all farmers had debt-to-asset ratios over 40 percent and negative cash flow; these farmers owed 45.3 percent of all farm debt.

Sources of Agricultural Credit

The distribution of agricultural debt at the end of 1984 was as follows.

	$ Billions	% of Total	%Change from 1983
Farm Credit System	67.9	31.9	-1.6
Commercial Banks	49.9	23.4	3.2
Individuals and others	48.1	22.6	-6.2
Farmers Home Administration	25.7	12.1	7.0
Life Insurance Companies	12.4	5.8	-2.1
Commodity Credit Corporation	8.9	4.2	-17.7
Total	212.9	100.0	-1.5

Farmers Home Administration (FmHA). The financial problems of the farm sector are adversely affecting the FmHA. From October 1 through June 19 of FY 1985, FmHA provided about $4.6 billion in direct and guaranteed loans to farmers -- a 92 percent increase over the same period in FY 1984. Direct loans made up 82 percent of the total credit provided. Most of the lending is to new borrowers. About 30 percent of all FmHA loans, or $8.5 billion, is delinquent. The higher lending in 1985 has increased the loss exposure on these loans.

The dramatic increase in FmHA exposure is due to its position as a "lender of last resort." The FCS and commercial banks are turning away many borrowers and directing them to the FmHA for their operating loans. Although these operating loans are not provided for real estate purposes, they enable the borrower to service his or her existing real estate debt. These loans have become de facto entitlements, which the FmHA virtually cannot foreclose.

Given current policy, the existence of the FmHA inhibits the restructuring of the farm sector, which further depresses land values and forces more borrowers out of the FCS and banks and into the FmHA.

A brief description of agricultural lending by the other two major lending groups experiencing difficulty -- commercial banks and the FCS -- is attached.

Actions Taken

In response to rising concerns about the deteriorating conditions in farm finances and the adequacy of operating credit, the Administration initiated in September 1984 a series of actions to provide adequate crop loans for 1985. These initiatives, along with greater credit from commercial banks and private individuals, resulted in all but about 5 percent of farmers obtaining operating credit for the current year -- instead of the 15 percent or higher shortfall predicted at the beginning of the lending season.

In February 1985, the Administration made a commitment to increase significantly short-term FmHA direct lending. The agency currently projects $4.25 billion will be lent directly by the end of FY 1985, compared with the $2.57 billion planned in the budget. The guaranteed lending program, after a slow start-up, should commit $1.1 billion by the end of FY 1985, compared with the $700 million planned in the budget.

The Agricultural Credit Problem

The fundamental problems now faced by farmers, and therefore by lenders to farmers, derive in large part from the farm subsidy system that has existed for the last 50 years, in which the government, rather than market forces, basically determine income. This has resulted in a severe demand-supply imbalance, which is the basic root of the problems faced by farmers, including agricultural credit. Consequently, a fundamental reform of farm policy directed at a market-oriented program is necessary to address the basic problems faced by farmers, as well as the agricultural credit problem.

The core of the agricultural credit problem is that there are substantial amounts of loan losses that will eventually have to be realized. The basic issue is who will absorb the losses -- private lenders or taxpayers through the Federal Government.

The Administration has several objectives in addressing the agricultural credit problem:

- It should establish a framework in which the flow of credit into the agricultural sector eventually conforms more closely with the market allocation of credit.
- It should minimize the short- and long-term budget costs of any solution.
- It should ensure that any credit solution is consistent with our overall agricultural policy.

Without policy changes, the agricultural credit problem will deteriorate rapidly in the next several months. The deteriorating credit conditions will adversely affect the FmHA particularly as more borrowers are forced to turn to it for credit. The potentially large demand for FmHA credit would undermine the Administration's efforts to reduce Federal spending.

Farmers Home Administration Options

Option 1: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Advantages

- o Closing the FmHA direct credit window and ending real estate loans minimizes Federal budget outlays which have grown at unprecedented rates.
- o Having the commercial market bear a significant portion of the risk on guaranteed loans helps insure the viability of these loans.
- o This reorientation of FmHA would promote the transition of unproductive resources out of agriculture and close down the de facto entitlement for all farmers rejected elsewhere in the credit system.

Disadvantages

- o Since this option would curtail loan activity more marginal farmers would have to liquidate their assets, hastening an already rapid decline in asset values.
- o Agricultural interests would strongly oppose this reorientation since it would effectively limit the flow of credit, particularly for real estate lending. Currently roughly 12 percent of FmHA loans are for real estate.
- o Farm income would decline further in the short run.

Option 2: Limit FmHA direct lending to servicing its existing portfolio. Limit FmHA real estate lending to no more than current levels. Continue FmHA guaranteed loans under existing authorities (maximum of 90 percent guarantee) under existing qualification rules.

Advantages

- Closing the direct credit window at FmHA eases the short-run pressure on budget outlays.
- Eases the adjustment for farmers by promoting a slower transfer of unproductive resources out of agriculture.
- This approach could be implemented through regulations and would not require congressional acquiescence.

Disadvantages

- Absorbing most of the risk on guaranteed loans promotes lower quality loans by commercial lenders, significantly increasing the ultimate Federal budget exposure.
- Continuing FmHA activity in a deteriorating land market enhances the possibility of long-term budget outlays for defaulted real estate loans.
- Some agricultural committee members may feel that the Administration has exceeded its regulatory discretion and move to block these changes through legislation.

Option 3: Limit FmHA direct lending to servicing its existing portfolio. Eliminate FmHA real estate lending. Authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

Consider creating a Federally-chartered, privately-owned credit institution (Aggie Mae) to purchase nonperforming farm real estate and equipment loans from any recognized financial institution.

Financial institutions (Farm Credit System, commercial banks, etc.) holding nonperforming real estate or equipment loans would obtain voluntary or forced liquidations. After foreclosure, the collateral would be sold on a discounted basis to Aggie Mae, which would be authorized to hold and manage the real estate or equipment for a period of from five to ten years.

The corporation would be authorized to lease the land or equipment to any qualified operator, including the current one, if qualified. It would use the proceeds to pay interest and principal on its securities. Aggie Mae, at its discretion, could dispose of land or equipment with the lessee retaining the right of first refusal at the time the holding was offered for sale. The potential cost to the Federal Government would be limited to the proportion of the Aggie Mae securities it guarantees, depending on economic conditions five to ten years out.

Advantages

- Agreeing to the creation of Aggie Mae could help achieve the needed reorientation of FmHA.
- Closing the FmHA direct credit window and ending real estate loans would reduce near-term budget outlays.
- By allowing the Farm Credit System and commercial banks to unload their nonperforming assets, it would permit them to remain a viable and competitive source of agricultural credit.

Disadvantages

- Creating Aggie Mae would inhibit the necessary restructuring of the farm sector by providing subsidized credit. It does not address the oversupply problem because it keeps land in production and may exacerbate it if the rents charged are forced below market due to political pressures.
- Creating Aggie Mae would establish a precedent for other troubled lenders, such as thrift institutions, to seek a similar dumping ground for problem loans.
- Creating Aggie Mae could result in a permanent Federally-chartered entity to manage and rent real estate and farm equipment.

Attachment

APPENDIX

Commercial Banks. At the end of 1984, about 5.1 percent, or $2 billion, of all commercial bank farm production loans were nonperforming, compared with 3.9 percent a year earlier. However, a significant proportion of nonperforming loans are held by money center banks. The number of rural agricultural bank failures has increased substantially during the current year, and the Federal Deposit Insurance Corporation (FDIC) expects over 50 agricultural banks to fail by year end -- just over half of all expected bank failures. With declines in land values continuing, many operating and real estate loans are becoming undercollateralized. Because most of the banks failing are very small, they have little impact on the banking system.

Cooperative Farm Credit System (FCS). The FCS was originally created as a government-sponsored enterprise. The FCS is able to borrow at about 5-20 basis points above Treasury securities because the market believes its securities are backed by the Federal Government, even though there is no explicit guarantee.

The overall condition of the FCS is basically sound. Of the $13 billion in stock, retained earnings, and loss allowances, the FCS has $4 billion to $6 billion in relatively liquid assets and also holds about $500 million to $1 billion of short-term lines of credit.

Notwithstanding the overall sound condition of the FCS, several elements of the system are facing severe financial difficulties. Several problem districts, particularly the Omaha district (including Nebraska, South Dakota, Iowa, and Wyoming), may require a total of about $1.8 billion within 60-90 days to stabilize their competitive position.

The fundamental problems faced by the FCS are twofold. First, the system is highly decentralized and operates on a consensus management basis. Because the FCS's equity is spread among about 900 separate entities and these entities are required to share losses only if there is a technical default, districts requiring additional equity in order to stabilize operations cannot easily draw on the reserves of other districts. Second, the Farm Credit Administration, which oversees the FCS, lacks regulatory authority and the necessary enforcement powers to require acceptable credit standards.